The gilt-edged market: developments in 1991

This note updates the information presented in three previous annual[1] articles which reviewed the evolution of the gilt-edged market since Big Bang. In 1991 there were a number of important developments in the gilt market. The government returned to borrowing in the gilt market after a period of over two years in which there had been no new gilt issues for cash and almost £14 billion of new issues were announced and sold in generally firm market conditions. The gilt-edged market makers (GEMMs) as a group recorded their second successive year of profits and, for the first time since Big Bang, the capitalisation of the market increased.

The first new gilt issue for cash since October 1988 was made on 24 January 1991, and new issues totalling £13.9 billion (nominal) were announced in the course of the year; of these, £2.3 billion fell in the 1990/91 financial year, and the remaining £11.6 billion in the current financial year. All new issues took the form of additions to existing stocks; no completely new stocks were created. As a consequence, after taking into account redemptions totalling £6.5 billion, the total nominal value of stock outstanding rose from £115 billion at end-1990 to £122 billion at end-1991; it was the first calendar year increase since 1987.

The new issues made during 1991 covered a broad maturity range (from three to twenty years) and included both conventional and index-linked stocks. Table A shows the maturity breakdown of all gilts in market hands (ie all those outside the public sector) as at end-1990 and end-1991. During 1991, the market's holdings of medium-dated conventional gilts (7–15 years) fell from 34.3% of total holdings at end-1990 to 31.0%, while holdings of short and long-dated conventional gilts rose. These movements reflect the effect of new issues, the natural shortening of the portfolio of gilts in market hands, and relative changes in gilt prices. The market's holdings of gilts have also been influenced by secondary market sales of stock from the Bank of England's own portfolio.

Last year's article reported on the results of the successful programme of gilt-edged conversions, the aim of which was to enhance the liquidity of the market by consolidating pairs of similar stocks into larger, single issues. Although no conversion offers have been announced since the return to issuing new stock in January 1991, the aims of the conversion programme have not been abandoned. Instead, the return to funding provided the opportunity to re-open existing gilt issues with additional tranches, thereby enhancing their liquidity by alternative means. At the same time, this policy has resulted in the creation of liquid benchmark issues, to the benefit of participants both in the gilt market itself and in the corporate bond market where they are used for the pricing of new issues.

Table A
Market holdings of gilt-edged stock: market value

Percentage of total holdings

	End-December 1990	End-December 1991	Change
Shorts (0–7 years)	38.0	39.9	+1.9
Mediums (7–15 years)	34.3	31.0	-3.3
Longs (15 years and over)	6.3	8.2	+1.9
Undated	0.9	0.9	—
Index-linked	20.5	20.0	-0.5

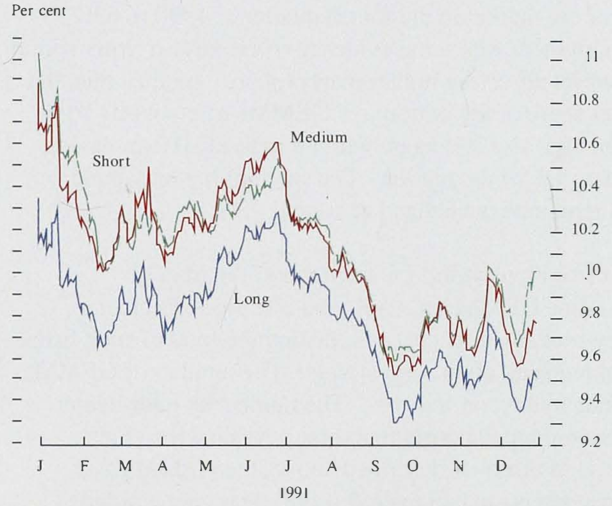
In 1991, the 5 and 10-year benchmark gilts were both re-opened on more than one occasion, and the opportunity was taken to build up a 20-year benchmark gilt. The market welcomed this development, which has had particular appeal for overseas investors, many of whom have become accustomed to concentrating on benchmark issues at similar maturities in other government bond markets. Looking ahead, there may be scope for further increasing the size of individual benchmark issues, provided that this is regarded as helpful by investors and market participants.

The transition from buying-in gilts to funding was gradual and proceeded smoothly. Since the return to funding, use has been made of most of the issuing techniques at the authorities' disposal—auctions, minimum price tenders and direct placings with the Bank for sale 'on tap' to the GEMMs in the secondary market, with stock being sold in both fully and partly-paid form. Just over 45% of new stock issued in 1991 was placed direct with the Bank; four auctions accounted for a further 40%; and the balance was issued by minimum price tender.

This mixed range of issuing techniques made it possible for the authorities to respond flexibly to investor demand as it arose throughout the year, using the series of auctions to provide the foundation for the 1991/92 funding requirement, to give the market confidence that it could be met, and augmenting this with tap sales. This flexible approach played a key role in facilitating the transition process, thus avoiding market disturbance. As Chart 1 shows, the gilt market performed strongly in 1991, the main feature being a sustained rally which began at the end of June and lasted until yields reached their lowpoint for the year on 20 September.

(1) 'The gilt-edged market since Big Bang', in the February 1989 *Bulletin*, pages 149–58; 'The gilt-edged market: developments in market-making in 1989', in the February 1990 *Bulletin*, pages 68–70; and 'The gilt-edged market: developments in 1990', in the February 1991 *Bulletin*, pages 49–52.

Chart 1
Yields on representative conventional gilt-edged stocks(a)



(a) Representative stocks: short - 10% Conversion 1996; medium - 10% Treasury 2001; long - 9% Treasury 2008.

Of the three methods of issuing gilts used in 1991, auctions represent a recent innovation; the first auction took place in May 1987 and a further three were held before funding was interrupted in October 1988.(1) There were four auctions in 1991, the results of which are set out in Table B. The first two were conducted on a similar basis to those in 1987/88, but, following a meeting with the GEMMs in July to review experience with these auctions, some minor technical modifications were made to the arrangements. These involved a shortening of the announcement timetable for auctions; changes to the pre-announced maturity ranges; and, at the GEMMs' request, a relaxation of the restrictions on switches of stock by the Bank during the 'fallow period' which follows each auction. The Bank's internal procedures were also improved in order to allow a more rapid announcement of the auction results, and this was broadly welcomed by the market as minimising disruption.

The auctions were successful—there was active bidding, the cover ranged from two to four and a half times, and the tail was never more than two basis points. In all four auctions the GEMMs accumulated substantial short positions during

Table B
Results of gilt-edged auctions in 1991

Stock	10% Conversion 1996 'B'	10% Treasury 2001 'B'	9½% Conversion 2004 'A'	9% Conversion 2011 'B'
Date held	24/4/91	26/6/91	25/9/91	27/11/91
Nominal amount (£ million)	1,200	1,500	1,500	1,500
Total value of bids (£ million)	5,375	3,290	2,901	3,414
Coverage (times)	4.48	2.19	1.93	2.28
Minimum yield at auction (per cent)	10.32	10.60	9.53	9.73
Average yield at auction (per cent)	10.34	10.61	9.54	9.74
Maximum accepted yield at auction (per cent)	10.35	10.63	9.56	9.75
Tail (basis points) (a)	1	2	2	1

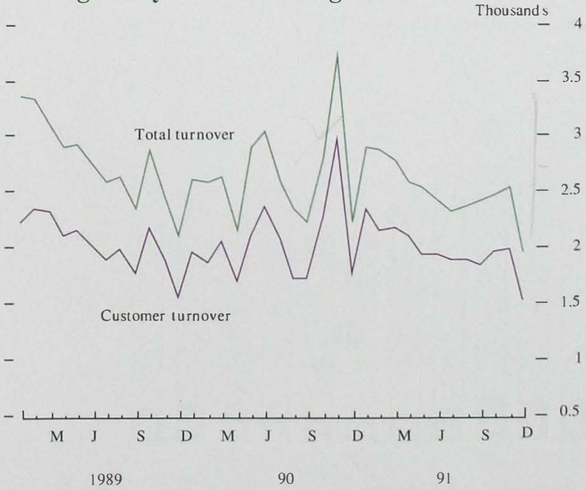
(a) Difference between maximum and average yield.

Chart 2
Average daily turnover: by value

the 'when-issued' trading period which precedes each auction. This in turn suggests that some investors may have a preference for buying ahead of the auction on a 'when-issued' basis which gives them the certainty of buying a known amount of stock at a preferred price.

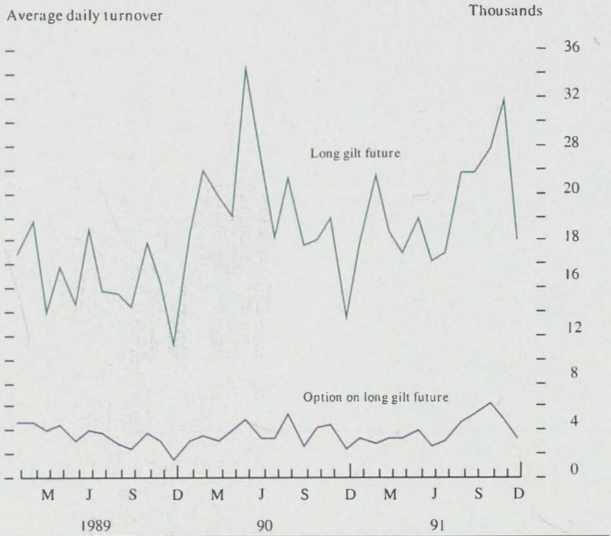
Chart 2 shows that total turnover by value in gilts increased slightly from an average of just under £4 billion a day in 1990 to around £4.4 billion a day in 1991, with continuing sharp fluctuations in the monthly pattern. Within this total, turnover by value with customers also increased, from an average of £1.8 billion a day in 1990 to just under £2 billion a day in 1991. The daily average of customer turnover reached a peak of £2.8 billion in October, and total turnover of £14.2 billion in the fourth quarter exceeded that in the previous three. This activity may well have resulted from the combination of substantial issuing during the period and market volatility following the peak in gilt prices on 20 September. Both the average size of customer deal and daily customer turnover by number of bargains (Chart 3) remained broadly unchanged from their 1990 levels at around £1 million and just under 2,000 a day respectively.

Chart 3
Average daily turnover: bargains



(1) Details of the first three auctions can be found in 'The experimental series of gilt-edged auctions', in the May 1988 *Bulletin*, pages 194-7.

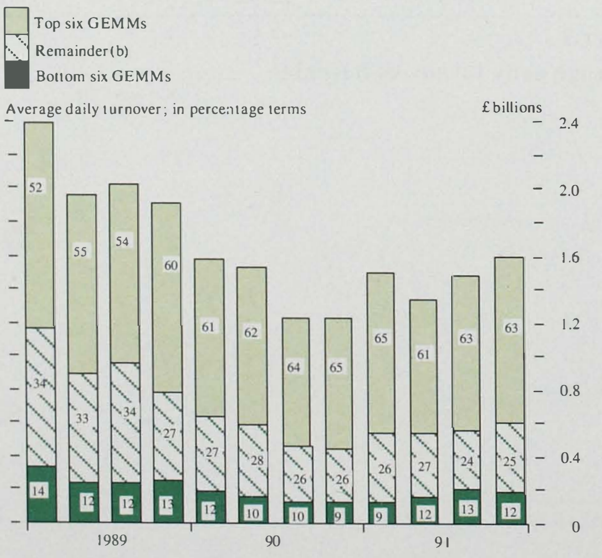
Chart 4
LIFFE gilt contracts: number of contracts



Turnover in 1991 in the LIFFE gilt derivatives—the long gilt contract and the option on the long gilt contract—increased slightly over 1990 levels (Chart 4). There was a marked rise in turnover in the long gilt future in the second half of the year, although concentrated largely in the fourth quarter. The average daily turnover in November exceeded 31,000 contracts, comfortably the highest of the year, in active trading around the November auction and as sterling weakened against the deutschemark.

In previous years, the analysis of the distribution of market share among GEMMs handling wholesale business (measured as share of outside turnover with clients and agency brokers) has supported the view that there continues to be strong competition among the GEMMs to provide the most effective service to investors. This view was reinforced in the course of 1991 when, as Chart 5 demonstrates, there was some reversal of the trend in recent years towards greater concentration of retail business in the hands of the six largest GEMMs. In 1991, the combined share of the top six GEMMs fell back slightly from around 65% of the market in the fourth quarter of 1990 to 63%, although there was some evidence of the largest firms within this subset attracting higher market share. Against this, the market share of the bottom six GEMMs rose slightly from around 10% to 12%, again with no individual firm having less than 1% of the market. The share of the remaining firms remained unchanged at around 25%.

Chart 5
Distribution of GEMMs' retail turnover (a)



(a) Excluding identified dividend business.

(b) The decrease in the share accounted for by this group in part reflects the reduced number of GEMMs.

Two institutions withdrew from the gilt market in 1991—one GEMM (in April) and one Stock Exchange money broker (in August)—reducing the total of such firms to eighteen and eight respectively. The number of GEMMs may rise in the coming year. The number of inter-dealer brokers remained constant at three. Against the slight increase in turnover described above, the GEMMs as a group again posted an overall profit. Having recorded annual post-tax profits of £40 million in 1990, the comparable figure for 1991 rose to £49 million, with a small number of individual GEMMs incurring losses. Details of the financial performance of the GEMMs as a group are shown in Table C.

Table C
Capitalisation of gilt-edged market makers

£ millions

	October 1986 to end-1988	1989	1990	1991
GEMMs' capital at beginning of period (a)	595	420	395	395
Net injections or withdrawals of capital	+ 15	-13	-40	-12
Operating profits (+)/losses(-) (b)	-190	-12	+40	+49
GEMMs' capital at end of period	420	395	395	432

Source: Bank of England.

(a) Capital base, as set out in the Bank of England's 'Blue Paper' ('The future structure of the gilt-edged market') published by the Bank in April 1985 and reproduced in the June 1985 *Bulletin*, pages 250–87.

(b) Net profits/losses after overheads and tax.

The overall post-tax return on capital dedicated to the gilt market in 1991 was 12.4%, although, as in previous years, a significant part of the total return was earned by the GEMMs on other, non-gilt market-making activities. As a consequence of the £49 million post-tax profit, and only a small (£12 million) withdrawal of capital, the capitalisation of the GEMMs as a group increased from £395 million at the beginning of the year to £432 million at the end. Thus 1991 was the first year since Big Bang in which the capital dedicated to the gilt market increased.

It would be misleading to attribute more than a small part of the improvement in the GEMMs' financial performance to the presence of new issues, since they cannot of themselves guarantee profitablity. But there can be little doubt that the growth of the gilt market (in terms of the nominal value of stock outstanding), after three successive years of contraction, acted as a stimulus to investor interest, as indicated by the slightly increased turnover figures. It also meant that, for the first time since 1988, the GEMMs were able to operate in the circumstances which they had expected to prevail when they prepared themselves for business at the time of Big Bang.

A number of other factors may have contributed to the improvement in financial performance in 1991, during which market conditions were generally favourable, and at times buoyant. The absence of particularly sharp market movements meant that, as a rule, GEMMs had time to close out positions as the market changed direction; but, on the other hand, generally low market volatility may have reduced the potential for profits. Measures taken by the GEMMs in previous years to tighten management and operational controls to contain costs and, where applicable, to integrate their business more closely within the wider groups of which they are part, continued to have a beneficial effect. A particular example of this would be the successful diversification of certain GEMMs' activities into other sterling fixed-interest bond business.

The continuing profitability of the GEMMs as a group in 1991, and the consequent increase in capital dedicated to the market, support the view which emerged in 1990 that the gilt market has entered a period of stability in its development following Big Bang. The increase in the size of the market, in terms of the amount of gilt-edged stock outstanding, has acted as a stimulus to investor interest and to liquidity, which the authorities' policy of creating benchmark stocks has also been designed to enhance.